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IN THE

Supreme Court of the United States

October Term, 1970
No. 544

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

LINCOLN SAVINGS AND LOAN ASSOCIATION,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

BRIEF FOR THE RESPONDENT.

A. CALDER MACKAY,
ADAM Y. BENNION,
RICHARD N. MACKAY,
VICTOR L. WALCH,
523 West 6th Street,
Los Angeles, Calif. 90014,
Attorneys for Respondent.

Parker & Son, Inc., Law Printers, Los Angeles. Phone 724-6622

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BRIEF FOR THE RESPONDENT.

Introduction.

The petitioner's statements of the "Opinions Below", "Jurisdiction", and "Question Presented" appear adequate. With respect to the "Statutes And Regulations Involved", in addition to those set forth in Appendices A, B and C of petitioner's brief, respondent believes the following are pertinent to the case:

Internal Revenue Code of 1954 (26 U.S.C.):

"SEC. 263. CAPITAL EXPENDITURES.

(a) General Rule—No deduction shall be allowed for

(1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. * * *"

Federal Home Loan Bank Act, c. 522, 47 Stat. 727 (12 U.S.C.):

"§ 1430. Advances—Authorization to make; limitation on amount

(a) Each Federal Home Loan Bank is authorized to make advances to its members upon the security of home mortgages, or obligations of the United States, or obligations fully guaranteed by the United States, subject to such regulations, restrictions, and limitations as the Board may prescribe. Any such advance shall be subject to the following limitations as to amount:

* * *

(c) * * * At no time shall the aggregate outstanding advances made by any Federal Home Loan Bank to any member exceed twelve times the amounts paid in by such member for outstanding capital stock held by it, or made to a nonmember borrower exceed twelve times the value of the security required to be deposited under subsection (e) of section 1426 of this title."

National Housing Act, c. 847, 48 Stat. 1246 (12 U.S.C.):

§ 1725. Creation of Federal Savings and Loan Insurance Corporation

(a) There is created a Federal Savings and Loan Insurance Corporation (hereinafter referred to as the "Corporation"), which shall insure the accounts of institutions eligible for insurance as hereinafter provided, and shall be under the direction of the Federal Home Loan Bank Board and operated by it under such bylaws, rules, and regulations as it may prescribe for carrying out

the purposes of this subchapter. The principal office of the Corporation shall be in the District of Columbia.

* * *

§ 1726. Insurance of accounts and eligibility provisions

(a) It shall be the duty of the Corporation to insure the accounts of all Federal savings and loan associations, and it may insure the accounts of building and loan, savings and loan, and homestead associations and cooperative banks organized and operated according to the laws of the State, District, Territory, or possession in which they are chartered or organized.

* * *

§ 1730. Termination of insurance and enforcement provisions—Voluntary termination of insurance

(a) Any insured institution other than a Federal savings and loan association may terminate its status as an insured institution by written notice to the Corporation specifying a date for such termination.

* * *

(d) In the event of the termination of an institution's status as an insured institution, insurance of its accounts to the extent that they were insured on the effective date of such termination as hereinabove provided in subsection (c), less any amounts thereafter withdrawn, repurchased, or redeemed, shall continue for a period of two years, but no investments or deposits made after such date shall be insured. The Corporation shall have the right to examine such institution from

time to time during the two-year period aforesaid. Such insured institution shall be obligated to pay, within thirty days after the effective date of such termination, as a final insurance premium, a sum equivalent to twice the last annual insurance premium payable by it. In the event of the termination of insurance of accounts as herein provided the institution which was the insured institution shall give prompt and reasonable notice to all of its insured members that it has ceased to be an insured institution and it may include in such notice the fact that insured accounts, to the extent not withdrawn, repurchased, or redeemed, remain insured for two years from the date of such termination, but it shall not further represent itself in any manner as an insured institution. In the event of failure to give the notice to insured members as herein provided the Corporation is authorized to give reasonable notice."

Statement.

Respondent believes that the "Statement" submitted by petitioner contains certain conclusions and argumentative matters (particularly in the third, fourth and fifth paragraphs thereof (Br. pp. 4-5) and in the full paragraph on page 8 of petitioner's brief). The "Statement" also is believed to be inadequate in not setting forth the differing functions of the FHLB and the FSLIC.

Respondent hopes it will facilitate the Court's consideration to substitute its own brief "Statement."

Respondent, a state-chartered (California) savings and loan association, is a member of the Federal Home Loan Bank of San Francisco, and insures its depositors'

accounts through the Federal Savings and Loan Insurance Corporation ("FSLIC"). At all relevant times, respondent has been a subsidiary of First Lincoln Financial Corporation, a corporation whose stock is publicly held and traded over the counter. It filed its federal income tax return for 1963, the taxable year herein in question, using the cash receipts and disbursements method of accounting.

The Federal Home Loan Bank Act (12 U.S.C. 1421 *et seq.*) was approved July 22, 1932, "to provide a reservoir of credit for thrift and home-financing institutions" and to "provide additional liquidity and funds for mortgage lending." Federal Home Loan Bank Board Annual Report—1963, p. 9. [Ex. 38, p. 9.] Each member was required to purchase FHLB stock equal to 2 percent of its outstanding mortgages. Having thus purchased FHLB stock equal to 2 percent of its outstanding mortgages, the association became entitled to borrow from the FHLB sums equal to 12 times the amount thus paid in for FHLB stock. (12 U.S.C. 1430 (a) and (c) *supra.*) Thus, the purchase of stock of FHLB gave to an association additional lending capacity for home mortgages.

Respondent became a member of the FHLB on March 4, 1936. (Appendix, p. 15.)

The Federal Savings and Loan Insurance Corporation ("FSLIC") was created by Congress on June 27, 1934 "to instill public confidence in our financial institutions through the insurance protection of savings." Federal Home Loan Bank Board Annual Report 1963, p. 23. [Ex. 38, p. 23.]

The FSLIC is charged by statute to insure accounts of eligible savings and loan associations. (12 U.S.C. 1726(a), *supra.*)

Respondent became an insured institution of FSLIC on June 6, 1938. (Appendix, p. 15.)

Respondent and all other insured institutions were required prior to 1962 to pay to the FSLIC a premium equal to ½ of one percent of the total amount of their respective savings accounts and creditor obligations until "a reserve fund has been established by the Corporation equal to 5 per centum of all insured accounts and creditor obligations of all insured institutions." 12 U.S.C. 1727. (Pet.'s Br. App. B, p. 47.) Thereafter, no insurance premiums would be payable unless and until the reserve fund were to drop below such 5 percent.

Such insurance premiums are deductible as ordinary and necessary business expenses, as the petitioner concedes. (Br. pp. 3, 16-17.)

On September 8, 1961, Congress enacted Public Law 87-210, which amended both the Federal Home Loan Bank Act and The National Housing Act, effective January 1, 1962.

The statute as amended required the FSLIC to "establish a Primary Reserve which shall be the general reserve of the Corporation and a Secondary Reserve to which shall be credited the amounts of the prepayments made by insured institutions pursuant to subsection (d) and the credits made pursuant to the first sentence of subsection (e)."

Under section 1727 (b)(1) as amended each insured association must continue to pay to the FSLIC a premium for such insurance equal to 1/12 of one percent of its insured savings deposits plus creditor obligations.

Under section 1727 (d) each insured institution "shall annually pay to the Corporation * * * an additional premium in the nature of a prepayment with respect to future premiums" equal to 2 percent of the net increase in its insured savings deposits, less an amount equal to any requirement for the purchase of stock of the FHLB, and "such prepayments shall be credited to the Secondary Reserve."

The amendment of the Federal Home Loan Bank Act reduced the FHLB stock purchase requirement from 2 to 1 percent of outstanding home mortgages.[1]

When at the close of any calendar year, the aggregate of the Primary Reserve and the Secondary Reserve equals or exceeds two percent of all insured accounts and creditor obligations of all insured institutions, the obligation of insured institutions to make Section 1727(d) payments is suspended until such aggregate amount falls below 1¾ percent of all insured accounts and creditor obligations; the obligation to make the Section 1727(d) payments is terminated forever when the amount in the Primary Reserve alone equals or exceeds two percent of all insured accounts and creditor obligations of all insured institutions. In any year in which the obligation to make Section 1727(d) payments is suspended, the pro rata share of each insured institution in the Secondary Reserve will be used, to

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[1]The Senate Report stated that the prepayments to the FSLIC would be offset, in approximately the same amounts, by such reductions in required FHLB stock purchases. S. Rep. No. 778, 87th Cong., 1st Sess. p. 2. As discussed hereinafter, this does not mean, as the Tax Court erroneously concluded, that the premium prepayments and the FHLB stock purchases serve the same purpose and are "fungible." They have nothing in common. The reduction in stock purchase requirement was to lighten the financial burden placed upon insured associations in requiring additional premium payments to the FSLIC.

the extent needed and available, to make Section 1727 (b) payments. Section 1727(g) (Pet's Br., Appendix C, pp. 55-56.)

According to FSLIC projections made in 1961, the aggregate of the Primary Reserve and the Secondary Reserve would equal or exceed two percent of all insured accounts and creditor obligations of all insured institutions by 1970, and the Primary Reserve itself would reach the two percent level in 1995 (R. 49-51.)

When the Primary reserve itself equals 2 percent of all insured accounts and creditor obligations, no premium under Section 1727(b) shall be payable by any insured institution except those in existence for less than twenty years, unless and until the primary reserve thereafter drops below such 2 percent.

During the year 1963 respondent received an insurance premium notice from the FSLIC and paid into the primary reserve of the FSLIC a premium under Section 1727(b) at the rate of 1/12th of 1 percent of its insured accounts and creditor obligations. During the same year respondent received a "Notice of Insurance Premium Prepayment" and paid into the secondary reserve of the FSLIC under Section 1727(d) the required amount, equal to 2 percent of its increase in savings accounts and creditor obligations.

Payments made by insured institutions into the secondary reserve of the FSLIC pursuant to Section 1727(d) have been credited on the books and records of the FSLIC directly to an account entitled "Secondary Reserve." Effective with the first payments pursuant to Section 1727(d) made by insured institutions, the FSLIC has maintained separate accounts for each insured institution showing, among other things, the

amount of payment pursuant to Section 1727(d), the interest credited by the FSLIC to the account pursuant to Section 1727(e), and the insured institution's pro rata share of the secondary reserve. Interest credited by the FSLIC to respondent's account was not reported on respondent's Federal income tax returns, nor was it added by the Commissioner to respondent's income upon audit of its returns. (Appendix, p. 17.)

Section 1727(e) of the statute provides that no right, title or interest of any institution in and with respect to its pro rata share of the secondary reserve shall be assignable or transferable, whether by operation of law or otherwise, except as provided by regulation for transfer in cases of merger, consolidation, or transfer of bulk assets, or similar transactions.

Sections 1727(f) and (g) provide that an insured institution may receive a cash refund of its pro rata share of the secondary reserve in the event that (1) its status as an insured institution is terminated, (2) a conservator, receiver, or other legal custodian is appointed for the purpose of liquidation, (3) the FSLIC determines that such institution has gone into liquidation, or (4) the primary reserve alone reaches 2 percent of all insured accounts and creditor obligations.[2]

Pursuant to regulations issued by the California Savings and Loan Commissioner and by the Federal Home Loan Bank Board, respondent reported its share of the FSLIC's Secondary Reserve as an asset on its balance sheets and on its published financial state-

[2]The estimates prepared by the FSLIC and submitted to the Senate Committee on Banking and Currency, and published as part of the Committee's report, were that there would be no premiums remaining in the secondary reserve at the time the primary reserve should reach the 2 percent level. S. Rep. 778, 87th Cong. 1st Sess.; Appendix, pp. 49, 50.

ments, and treated the interest credited on such share as income. [R. 53.] Respondent's parent, although not subject to federal or state accounting regulations, likewise treated respondent's share of the Secondary Reserve as an asset on its consolidated financial statements. The firm of Peat, Marwick, Mitchell & Co., certified public accountants, stated in their audits of respondent's financial statements and those of its parent for the years 1962 through 1966 that respondent's financial position and the consolidated financial position had been presented fairly therein, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year. [R. 53, 68.]

On its federal income tax return for 1963, respondent deducted both its Section 1727(b) and Section 1727(d) payments as ordinary and necessary business expenses under Section 162(a) of the Internal Revenue Code. [R. 54.] The Commissioner allowed the former, but disallowed the latter. [R. 55.] In a unanimous reviewed opinion [R. 39-75], the Tax Court agreed with the Commissioner. It held that the Section 1727(d) payments constituted a nondeductible capital investment in FSLIC, and that such payments could be deducted only when used to pay regular annual insurance premiums or to meet actual losses of FSLIC. A divided court of appeals reversed and held the Section 1727(d) payments to be currently deductible business expenses. [R. 76-84.]

This Court granted the Commissioner's petition for certiorari on November 9, 1970. [R. 85.]

Summary.

Respondent is a California savings and loan association. It encourages people to deposit their savings with it; and in turn it loans out the savings thus deposited to people who want to buy or build homes.

To encourage home building the Federal Government created the Federal Home Loan Bank System, so that savings and loan associations such as respondent could invest money in the stock of FHLB and thereby become entitled to borrow from the FHLB twelve times the amount thus invested in FHLB stock, thus greatly increasing the funds which respondent could in turn loan out to home buyers or builders.

This was and is the primary purpose and function of the FHLB—to provide funds which savings and loan associations in turn can loan on mortgages. The FHLB had and has nothing whatever to do with insurance.

But, on the other hand, it is an important part of respondent's business to be able to assure its savings depositors that the Federal Government stands behind their savings.

The technique of furnishing this assurance was the creation of the FSLIC, an agency of the Federal Government, distinct from the FHLB although supervised by it, which was charged with the statutory duty of insuring the savings accounts of any depositor of an insured savings and loan association up to $5,000 initially, later increased to $10,000 and $15,000 and now to $20,000.

The FSLIC is in effect a mutual insurance company. It has no capital stock outstanding and has no authority from Congress to obtain any capital stock.

Its sole duty is to insure the savings accounts of depositors in insured institutions, and to do so it must have a reserve for insurance losses, which losses it has been required by statute to assume.

The building up of such a reserve for insurance losses has been the function of premiums required by Congress to be paid to FSLIC by its insured members. The statutory duty of the FSLIC to insure savings accounts of insured associations exists only so long as each association pays to the FSLIC the premiums for such insurance prescribed by Congress.

Because of the very rapid increase in savings deposits during the Fifties, Congress in 1961 became alarmed at the inadequacy of the FSLIC's reserve for insurance losses. That is to say, its potential risk as an insuror had become inordinate in the light of the reserve which it held against such risk.

Congress proceeded in 1961 to solve the problem by requiring a more rapid build-up of the FSLIC's reserve for insurance losses. It did not do this by authorizing the FSLIC to issue stock, which would stand as a capital reserve, either temporary or permanent. There is no such authority in the statute. It should be noted here that the FSLIC was originally capitalized with stock issued to the Home Owners Loan Corporation. (Appendix, p. 16.) If Congress had intended to convert the FSLIC from what was essentially a mutual insurance company to a stock insurance company in 1961 it could easily have done so since there was good precedent for doing it. Instead, Congress decided to retain the basic characteristics of the FSLIC as a mutual insurance company and merely increase the reserves for losses through additional premiums.

The petitioner concedes that the initial premium is deductible for income tax purposes as an ordinary and necessary business expense.

The petitioner contests the deduction for income tax purposes of the additional premium, conceding that it was "necessary", but contending that it was not "ordinary", in the sense that it might produce a benefit in a future year or years.

Respondent respectfully urges that the payment of the additional premium was "ordinary" within any accepted meaning of that word, in that all those similarly situated chose to pay it—and that is the meaning of the word "ordinary" as enunciated by this Court.

The fact that a payment may produce a benefit in a future year or years is not the criteria for distinguishing between an expense deduction and a capital expenditure. In fact, innumerable expense deductions produce benefits in years subsequent to their payment —as indeed the initial or primary premium payments in this case will inevitably do.

The answer lies in the nature and purpose of the payment: was it really made primarily for insurance coverage, not only for the current year but for any future year or years in which a savings may occur, or was it really made as a capital investment in preference to other ways in which the respondent may have preferred to use the $882,636.86 required to be paid to the FSLIC.

Of the four courts that have passed upon the question, three have been persuaded that the payment was in essence an expense for current insurance protection; that any future benefit that may be derived therefrom was not only speculative but was no different

than the benefit that may be derived in the future from having paid the intitial or primary premium; that the association did not in fact or substance make a capital contribution to the FSLIC; that the so-called return on the Secondary Reserve account of an association is illusory, being nothing more than a bookkeeping entry of FSLIC transferring funds from the Primary Reserve to the Secondary Reserve, both of which combined must reach the 2 percent level before any benefit will accrue to anyone; and that the possibility of a refund of the Secondary Reserve to any association was so remote and contingent that, under decided cases, such possibility does not preclude the deduction in the year of payment. *Lincoln Savings and Loan Association v. Comm.*, (C.A. 9) 422 F. 2d 90; *Washington Fed. S. & L. Assn. of Miami Beach v. U.S.*, (S.D. Fla.) 304 F. Supp. 1072, appeal pending; and *First Fed. S. & L. Assn. of St. Joseph v. U.S.*, (W.D. Mo.) 288 F. Supp. 477.

Only the Tax Court reached a contrary conclusion. Its decision was based upon two fundamental errors: (1) it stressed that the payments "are not really insurance premiums, at least not in the year in which they are paid" (Appendix, p. 59); and (2) it brought itself to believe that there was a "fungibility" of the Secondary Reserve premium payments and FHLB stock investments (Appendix, p. 67.)

The plain fact is that respondent paid the $882,636.86 of secondary premiums to the FSLIC in 1963 solely because it had to do so in order to continue as an insured institution of the FSLIC. Had it not made the payment it would not have been insured by the FSLIC for the year 1963. To say that the payment

did not procure insurance coverage for the year of payment is simply wrong. Insurance coverage for the year of payment could not have been obtained without the payment.

The FSLIC annually sends the taxpayer two bills, one for the primary premium (which the petitioner concedes is a deductible expense) and one for the secondary premium. Both must be paid to maintain the insured status, and by making both payments and only by making both payments does the respondent maintain its insured status.

These are the precise elements that constitute the obtaining of "insurance coverage" in the year of payment. The primary premium payments, which the petitioner admits do provide current insurance coverage, contain precisely the same elements: they must be paid to maintain the insured status, their payment in fact maintains the insured status, their only purpose is to maintain the insured status, and failure to pay them would cause the termination of the insured status. If the primary premium payments provide current "insurance coverage," and if precisely the same compulsion to pay, purpose in paying and consequence of failure to pay exist with respect to the secondary premium payments, how can it be said that the secondary payments do not equally provide insurance coverage?

We shall address ourselves hereinafter to the Tax Court's error in attempting to make the secondary premium payments "fungible" with FHLB stock purchases. This exhibits a complete misunderstanding of the two distinct functions performed by the FHLB and the FSLIC, and indeed a statement of Congressional purpose diametrically opposed to the stated purpose of Congress.

ARGUMENT.

I.

The Secondary Reserve Premium Payment Was an Ordinary and Necessary Business Expense of Respondent.

The Internal Revenue Code levies an income tax upon the net income of all taxpayers, permitting them to deduct "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." (26 U.S.C. 162).

Pursuant to the Act of Congress under which it operates, respondent during the year 1963 responded to the Congressional directive that it "shall annually pay to the Corporation [FSLIC] * * * an additional premium in the nature of a prepayment with respect to future premiums * * * equal to 2 percentum of the net increase in all accounts of its insured members," amounting to an additional premium of $882,636.86.

Respondent deducted said sum of $882,636.86 in determining its net income for income tax purposes, as an ordinary and necessary expense of carrying on its trade or business.

Petitioner disallowed the deduction. Petitioner concedes that the payment was "necessary", but contends that the payment was not "ordinary".

Respondent respectfully submits that the payment was "ordinary" within any definition of that term and particularly within the meaning of "ordinary" heretofore given by this Court.

In the celebrated case of *Welch v. Helvering*, 290 U.S. 111, Mr. Justice Cardozo stated:

"* * * Now, what is ordinary, though there must always be a strain of constancy within it, is none the less a variable affected by time and place and circumstance. Ordinary in this context does not mean that the payments must be habitual or normal in the sense that the same taxpayer will have to make them often. A lawsuit affecting the safety of a business may happen once in a lifetime. The counsel fees may be so heavy that repetition is unlikely. None the less, the expense is an ordinary one because we know from experience that payments for such a purpose, whether the amount is large or small, are the common and accepted means of defense against attack. Cf. *Kornhauser v. U.S.*, 276 U.S. 145. * * *"

In the present case there can be no question but that the payment of the secondary reserve premium was "ordinary" in the sense that all associatiions similarly situated did in fact pay it. The Annual Reports of the Federal Home Loan Bank Board disclose that total insured associations numbered 4,419 at December 31, 1963, 4,463 at December 31, 1964, 4,508 at December 31, 1965 and 4,510 at December 31, 1966. (Federal Home Loan Bank Board Annual Report—1963, p. 24 [Ex. 38, p. 24] 1964, p. 33 [Ex. 39, p. 33] —1965, p. 58 [Ex. 40, p. 58]—1966, p. 61, [Ex. 41, p. 61].) The FSLIC secondary reserve increased as follows:

December 31	Secondary Reserve
1962	$171,000,000
1963	365,000,000
1964	590,000,000
1965	812,000,000
1966	999,000,000

(Annual Reports, 1963 (p. 68), 1964 (p. 107), 1965 (p. 125), 1966 (p. 120)).

No insured association terminated its insured status during 1962, 1963, 1965 or 1966, and only one association did in 1964 in favor of a state insurance program. (Federal Home Loan Bank Board Annual Reports—1962 (p. 37)—1963 (p. 25)—1965 (pp. 58-59)—1966 (pp. 61-62).) And in 1966 occurred the only case in the history of the FSLIC in which it exercised its statutory authority to terminate insurance. Federal Home Loan Bank Board Annual Report—1966, pp. 61-62. [Ex. 41, pp. 61-62.]

It can only be concluded from the foregoing that payment of the secondary reserve premium was an "ordinary" expenditure to make.

II.

The Possibility of a Future Benefit Does Not Convert an Ordinary and Necessary Business Expense Into a Capital Expenditure.

Petitioner has constructed an argument to the effect that the benefits to be derived from a deductible business expense must be "exhausted" in the year of payment, whereas an expenditure, if it produces benefits that may be enjoyed in future years, must be capitalized.

We respectfully submit that there is no such rule in the tax law.

Many, many expenses are deductible though they produce benefits in future years.

One of the most obvious examples is found in one of the first cases cited by petitioner, *Commissioner v. Tellier*, 383 U.S. 687. The taxpayer there was convicted of securities fraud and had been sentenced to four and one-half years in prison. He expended sums to defend against the charges and the income tax case involved

the deductibility of the sums thus spent, although unsuccessfully.

This Court held that the amounts paid in defense were deductible as ordinary and necessary business expenses, saying:

> "* * * The legal expenses deducted by the respondent were not capital expenditures. They were incurred in his defense against charges of past criminal conduct, not in the acquisition of a capital asset. Our decisions establish that counsel fees comparable to those here involved are ordinary business expenses, even though a lawsuit affecting the safety of a business may happen once in a lifetime. *Welch v. Helvering, supra,* at 114. *Kornhauser v. U.S. supra,* at 152-153; * * *"

The important point here is that the payments in question were made to procure a benefit that would have inured far beyond the year of payment. The taxpayer was attempting to prevent his going to prison for four and one-half years. The expenses were incurred in an attempt to prevent that. The benefit obviously would have been keenly felt for four and one-half years, and probably during the lifetime of the taxpayer. Yet, this Court held that the payment was a currently deductible ordinary and necessary business expense.

Even more in point is the case of *Commissioner v. Heininger,* 320 U.S. 467, where the taxpayer was allowed a deduction for expenses incurred by him in resisting an order which threatened to terminate his business. An expense to save a business certainly will be of benefit far beyond the year of payment, yet the

expense was a deductible ordinary and necessary business expense.

Repairs are another type of expenditure which, though often substantial in amount and resulting in benefits over many future years, are currently deductible. The income tax regulations, Sec. 1.162-4, allow the deduction of such repairs if they "neither materially add to the value of the property nor appreciably prolong its life." But repairs are currently deductible although they may be of benefit throughout the existing life of the property repaired.

Again, the income tax regulations, Sec. 1.162-5, allow a deduction for education expense which "maintains or improves skills required by the individual in his employment or other trade or business" or "meets the express requirements of the individual's employer."

It seems obvious that expenses of education, such as lawyers today customarily incur under the worthwhile continuing education of the bar programs sponsored by the American Bar Association and local bar associations, will produce benefits extending beyond the year of payment for such education, and yet the costs are universally deducted as current business expenses.

But, to bring the matter closer to home:

In I.T. 2764, C.B. XIII-1, 1934, the question presented was whether amounts paid by member banks into the temporary Federal deposit insurance fund, created under the Banking Act of 1933, were deductible for income tax purposes. Because of the rash of bank failures, Congress in 1933 established a temporary Federal deposit insurance fund to cover a period of six months from January 1, 1934 to June 30, 1934. Mem-

ber banks were required to make payments into the fund in 1933. Upon the discontinuance of the fund on June 30, 1934, any unused portion of the temporary fund was to be returned ratably to the member banks. The Internal Revenue Service held as follows:

> "In the opinion of this office the amount actually paid into the fund, as distinguished from the amount subject to call, constitutes an ordinary and necessary business expense under section 23-(a) of the Revenue Act of 1932 and *is deductible by the bank in its return for the taxable year in which payment is made irrespective of the contingency whereby a part of the amount paid may later be returned to the member bank.* (G.C.M. 8474, C.B. IX-2, 281.) If a part of the amount paid into the fund and deducted as a business expense is returned to the taxpayer, the amount so returned constitutes income for the year in which received. (G.C.M. 10798, C.B. XI-2, 58)" (Emphasis supplied.)

From the close of 1933, the tax year in which the payments were made, *only six months* were to elapse before it would be known whether the payments would be returned to the member banks. Yet, because tax accounting must be conducted on an annual basis, the Internal Revenue Service held the payments deductible in 1933. By contrast, in the instant case an indefinite number of years may elapse before it becomes known whether any part of respondent's 1963 payment will or will not be recovered. It follows, *a fortiori,* that the payment in the instant case is deductible in 1963.

Nine years later, the Internal Revenue Service issued another pronouncement of the same rule, as applied to facts even more similar to the facts of the instant

case. In I.T. 3632. C.B. 1943, 114, State banks in Indiana were required to make annual payments to a newly created Public Deposits Insurance Fund. The law provided that at such time as the insurance fund might exceed a minimum amount fixed by the Board of Depositories, excess funds would be returned pro rata to the contributing banks. The Internal Revenue Service held as follows:

> "It is held that the assessments in question, which are fixed by the board for depositories and are required to be paid by Indiana banks into the treasury of the State of Indiana, are deductible for Federal income tax purposes as business expenses for the year in which paid or accrued. If, following the audit of the books of the Public Deposits Insurance Fund at biennial intervals, any part of the amounts paid into the State treasury (for the benefit of the fund) and deducted as business expenses is returned to a participating bank, the amount so returned is includible in gross income for the year in which received. (Cf. I.T. 2764, C.B. XIII-1, 45 (1934).)"

As early as 1927 the Board of Tax Appeals adopted and applied the same principle. In *First State Bank of Brackettville* (1927), 9 BTA 975, the Board rejected the Commissioner's contention that payments by a bank into the Texas Depositor Guaranty Fund were non-deductible because of the possibility of refunds being made to the bank. The Board stated:

> "The petitioner having paid the amount in question pursuant to a definite liability fixed by law, the contingent possibility of a refund of some or all of the amount so paid does not render the

amount a non-deductible item. It seems clear that if the right to the deduction is denied the petitioner, its net income for the year in question could not be rightly determined. . . . If the contingency ever arises upon which a refund is realized out of the payments made in 1920, the amount so realized should be treated as income for the year during which it is realized."

The Board also stated at page 979:

"It is clear, therefore, from the foregoing provision of law (providing for the distribution to the contributing bank of its pro rata share in the depositor guaranty fund upon voluntary liquidation) that during 1920 the petitioner was not entitled to any part of the amount paid into the fund. As a condition precedent to the possibility of a refund, the petitioner would have to voluntarily liquidate and pay all of the outstanding obligations to all depositors in full. There was no statutory authority under which a refund could be made so long as petitioner continued to do business, the fund by reason of the failure of member banks might become depleted to such extent that petitioner's reversionary interest in the amount paid in in 1920 would be entirely extinguished."

In *Alleghany Corporation* (1957), 28 T.C. 298, sums paid by the taxpayer in opposing reorganization plans were held to be deductible notwithstanding the Commissioner's argument that there existed a possible right of recovery of part or all of the expenses. The Court stated at page 305:

"Neither do we think the deductions claimed should be denied in the years in which they were

incurred simply for the reason that there was a possibility that at some future date petitioner might receive a reimbursement for some of the expenditures. One of the elementary principles of Federal income tax accounting is that income and deductions must be accounted for on an annual basis in accordance with the method of accounting employed by the taxpayer. See *North American Oil Consolidated v. Burnet*, 286 U.S. 417 (1932). Petitioner employed the accrual method and under that method is entitled to deduct expenses as they accrue. The case of *Richard A. Drachman*, 23 T.C. 558, cited by respondent, does not support his contention. In that case the taxpayer had been treated as a general creditor with respect to his claim for reimbursement and, accordingly, as a debtor-creditor relationship existed, the deduction was disallowed for the year in which the reimbursable payment was made. In the instant case, no debtor-creditor relationship existed as to any of the payments, there being only a contingent possibility of reimbursement."

The last sentence quote above has particular significance here. The fact of the matter is that there is no debtor-creditor relationship existing between the FSLIC and respondent with regard to the secondary reserve. We have noted above that the secondary reserve is not a liability of the FSLIC owing by it to respondent or any other creditor. It is a reserve available to the FSLIC to meet losses of the entire savings and loan industry. Any recovery by or future benefit to respondent is purely contingent.

In *Electric Tachometer Corporation* (1961), 37 T.C. 158, the Commissioner sought to disallow moving ex-

penses caused by condemnation proceedings upon the ground the taxpayer was attempting to procure reimbursement for such expenses from the state. But the Court allowed the expense deductions, stating at pages 161 and 163:

> "* * * However, an otherwise proper deduction should not be disallowed in the year in which it is paid or incurred because of the existence of a possibility that at some future date the taxpayer might receive a reimbursement therefor. * * *"
>
> * * *
>
> "Under these facts, the right to receive reimbursement was not sufficiently fixed to make the expenditure in the nature of an advance or something other than an expense incurred in petitioner's business. * * *"

The principle has been applied uniformly, whether its application would happen to favor a taxpayer or the Internal Revenue Service. Thus, in *George K. Herman Chevrolet, Inc.* (1963), 39 T.C. 846, income was taxed to the taxpayer upon its receipt of an item of advertising expense previously paid out, the taxpayer seeking to escape such result by contending that the initial payment did not constitute an expense because of the possibility of refund that actually ensued. But the Court taxed the recovery and reiterated the familiar rule at page 853 that an otherwise proper deduction should not be disallowed in the year it was paid or incurred because of the existence of a possibility that at some future date the taxpayer might receive a reimbursement therefor.

With respect to advertising expense, the principle which respondent believes to be controlling here is

well stated in *E. H. Sheldon & Co. v. Comm.* (C.A. 6, 1954), 214 F. 2d 654:

> "The effect of advertising, by its nature, is usually not limited to the year in which it is done, but has a useful life somewhat indefinite in the future. The fact that an expenditure produces something that has a useful life extending beyond the taxable year is clearly not the controlling test. *J. H. Collingwood*, 20 T.C. 132; *Perkins Bros. Co. v. Comm.*, 78 Fed. (2d) 152, C.A. 8th; *Marsh Fork Coal Co. v. Lucas*, 42 Fed. (2d) 83, C.A. 4th; *New Pittsburgh Coal Co. v. U.S.*, 200 Fed. (2d) 146, C.A. 6th. It has been held a number of times that advertising expense, even though incurred heavily in a certain year with resulting benefits over future years, is nevertheless a deductible expense for the year in which expended. *Northwestern Yeast Co.*, 5 B.T.A. 232; *Colonial Ice Cream Co., supra* [7 B.T.A. 154]; *F. E. Booth Co., supra* [21 B.T.A. 148]; *A. Finkenberg's Sons, Inc.*, 17 T.C. 973, 982-983; *Consolidated Apparel Co.*, 17 T.C. 1570, 1582; *Richmond Hosiery Mills v. Comm.*, 29 Fed. (2d) 262, C.A. 5th."

The most recent example of the rule that a possible or probable future benefit does not preclude a present deduction of a payment is contained in Rev. Rul. 70-577, issued November 16, 1970, I.R.B. 1970-46, 8:

> "It is held that a taxpayer who makes a lump-sum payment into the Wisconsin unemployment reserve fund during the current taxable year under the provisions of section 108.18 (7) of the Act is entitled to deduct such payment as an ordinary and necessary business expense in his Federal in-

> come tax return for that year, regardless of whether his books or accounts are kept on the cash receipts and disbursements method or on the accrual method, and notwithstanding the fact that such payment effects a reduction in the amount that would be paid in a year subsequent to the year in which paid. Furthermore, the fact that a payment made in the current taxable year may be credited under the Act to a prior year, does not affect its deductibility in the current taxable year for Federal income tax purposes."

Petitioner seeks to dismiss certain of the foregoing citations in footnote 24 of his brief (p. 28) by saying that they are irrelevant since the principle of the cited cases applies only where the expenditures are conceded or determined to be "ordinary" business expenses.

We submit that petitioner's attempted distinction is without merit. In each case the Commissioner sought to deny a current deduction upon the ground that the taxpayer might or probably would realize a benefit in a future year. That is exactly the argument of petitioner here. He does not question the fact that the payment is deductible. It is only a question of *when* it is deductible. In all of the above cases the Commissioner lost in his argument that a current deduction should be disallowed because of a possible future benefit. We submit he should likewise lose here.

In view of all the foregoing, we submit that the possibility of a future benefit does not preclude a present deduction for an ordinary and necessary business expense paid.

But we submit there is an even more fundamental fallacy in petitioner's argument regarding future benefits. And that is that the primary premium, which is concededly deductible, is as much responsible for any future benefit as the secondary premium.

The benefit to be derived in a future year will occur only when and if the primary reserve and the secondary reserve combined have reached 2 percent. Upon the occurrence of that event, who is to say that the benefit thereupon flowing to respondent was any more attributable to its payment of the secondary premium than to the payment of the primary premium? It seems impossible to deny that the benefit in that particular year would not have resulted if either premium had not been paid.

Moreover, when the primary reserve alone reaches 2 percent every insured association is going to enjoy the benefit of non-payment of premiums, and that benefit certainly will have been "purchased" by payment of primary premiums during the history of the FSLIC equally as well as the payment of secondary premiums. As a matter of fact conceivably there could be those in existence who will enjoy that future benefit and who never had occasion to be required to pay secondary premiums.

A. The Real Test Centers in the Nature and Purpose of the Payment.

It is interesting that the Internal Revenue Code contains a section allowing a deduction for all the ordinary and necessary business expenses paid or incurred in carrying on any trade or business, Sec. 162 (Pet's. Br. p. 41); and it also contains a section disallowing any deduction for capital expenditures. Sec. 263, *supra.*

The interesting point is that the petitioner contends that the payment in dispute here is a capital expenditure, and yet it does not even cite or quote the section of the Internal Revenue Code dealing with capital expenditures, namely, section 263.

One reason for this omission, we suspect, is that the payment in dispute here is not a capital expenditure within the meaning of section 263: it is not an amount paid out "for new buildings or for permanent improvements or betterments made to increase the value of any property or estate."

Taxpayers normally deduct the cost of capital expenditures by way of depreciation deductions under section 167 of the Internal Revenue Code, which allows as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear of property used in a trade or business or property held for the production of income.

We have rather a payment required by Congress to remain an insured member of the FSLIC. Whether a payment is a deductible expense or a capital expenditure, we repeat, is dependent upon the nature and purpose of the expenditure. As three courts have heretofore held, including the Ninth Circuit below, the nature and purpose of the payment in dispute here characterize it as an ordinary and necessary business expense.

III.

The So-Called "Return" Credited to the Secondary Reserve Is Illusory.

The petitioner emphasizes the fact that interest is credited to the secondary reserve, in support of the argument that the secondary premium payments are capital expenditures.

However, the interest thus credited is not available to the insured institutions, and even the Internal Revenue Service concedes that insured associations are not taxable upon such interest at the time of the crediting. Rev. Rul. 66-49, C.B. 1966-1, 36.

The legislative history is interesting on this point. The Chairman of the legislative committee of the U.S. Savings & Loan League testified that it would be desirable if the interest on secondary reserve payments were paid to the associations in cash, as dividends were received in cash on the FHLB stock. Instead, he had learned only the preceding evening that the bill did not provide for the payment of interest in cash, but simply a credit to the secondary reserve, which would remain subject to all the restrictions governing that reserve. And of course it would be subject to payment of insurance losses, if need be. He therefore volunteered to supply an amendment to provide for such cash payment of interest. H. Hearings Before Subcommittee on Banking and Currency on H.R. 7108 and 7109, 87th Cong. 1st Sess., pp. 39-43.

However, it apparently was decided not to present such an amendment, and the observations of the witness appear to have fallen on deaf ears, for there was no change in the bill with respect to this matter.

Here, we submit, is additional evidence that Congress was concerned primarily with building up the insurance reserves of the FSLIC, and was not intending to provide for a capital investment which would provide a cash return to investors.

The FSLIC receives money—both primary and secondary premium payments—and it invests the money in Government bonds. It does not earmark the bonds, this bond as a primary reserve bond and that bond as a secondary reserve bond. Rather, it receives all the interest on all its Government bonds, treating it all as income. Then it credits a return to the Secondary Reserve as the statute requires. This credit is treated as an expense or a deduction from what it is pleased to call its income, with the result that the Primary Reserve, to which is credited its so-called net income, is reduced by exactly the same amount as is credited to the Secondary Reserve.

But this crediting has absolutely no effect upon the size of the combined Primary and Secondary Reserves. One is decreased, the other increased. The important point is that for all important purposes under the Act, *i.e.*, when the combined reserves reach 2 percent, the so-called return could be in either reserve. It wouldn't make any difference. And since the so-called return is not available for use to the taxpayer, as the Internal Revenue Service admits, it doesn't make any difference to the taxpayer either.

In other words, the crediting of a return from one reserve to the other is totally immaterial.

IV.

The Three Circumstances Under Which Respondent Could Recover the Insurance Premium in Controversy Are Such That They Do Not Render the Expense Non-Deductible.

There are only three circumstances under which any portion of the secondary reserve could conceivably be returned to respondent:

1. In the event of its voluntary liquidation.

2. In the event of its termination as an insured FSLIC institution.

3. In the event the primary reserve alone should ever reach 2 percent of all savings accounts and creditors obligations of all insured institutions.

We shall consider these three factors separately.

A. Recovery Conditioned Upon Voluntary Liquidation Does Not Convert an Expense Into an Asset.

We submit it would be grossly improper to treat an expenditure as an asset instead of an expense upon the theory that the expenditure might be recouped by going out of business and dissolving. Such a view would be completely contrary to proper accounting procedures and to decided cases.

In the well-known text of Montgomery's Auditing, Eighth Edition (The Ronald Press Company, New York, 1957), edited by partners of Lybrand, Ross Bros. & Montgomery, the principle is stated on page 94 that "financial statements are presumed to be those of a going concern". And in the book "Inventory of Generally Accepted Accounting Principles For Business Enterprises", an accounting research study by Paul Grady, published in 1965 by the American Institute

of Certified Public Accountants, Inc., we find the following under the heading "Going Concern" and in the chapter entitled "Basic Concepts To Which Accepted Accounting Principles Are Oriented" (p.27):

> "It is a commonplace that business activity has changed over the past century or so from a series of separate ventures to a pattern of continuous activity. As a consequence, a large part of accounting practice as well as theory is based on the presumption that the accounting entity will continue in operation and not be liquidated in the foreseeable future. In the absence of evidence to the contrary, the entity should be viewed as remaining in operation indefinitely.
>
> "Corporate managements must view their operations as a continuing process. No enterprise of any consequence could operate from day to day under the cloud of expected liquidation. * * * All of these factors support the basic proposition that business management assume, and properly so, the indefinite continuation of operations."

Hence, we submit that under generally accepted accounting principles there should be disregarded any possibility of a return of an expenditure based upon the liquidation of the enterprise as a condition precedent to such return.

This is in accord with cases already cited. The Board of Tax Appeals in *First State Bank of Brackettville* (1927), 9 BTA 975, ignored such a possibility saying, "As a condition precedent to the possibility of a refund, the petitioner would have to voluntarily liquidate and pay all of the outstanding obligations to all depositors in full."

Thus, the first possibility of a return, *i.e.*, liquidation, cannot be relied upon to disallow an expenditure as an expense and to treat it as the acquisition cost of a capital asset.

B. Termination of Insurance Is a Business Impossibility and Does Not Convert an Expense Into an Asset.

Section 1730 of Title 12 of the United States Code provides that any insured institution "may terminate its status as an insured institution by written notice to the Corporation", in which event insurance of its accounts shall continue for a period of two years, such insured institution shall be obligated to pay, within thirty days after any such notice or order of termination, as a final insurance premium, a sum equivalent to twice the last annual insurance premium paid by it, and the institution shall give prompt and reasonable notice to all of its insured members that it has ceased to be an insured institution and it may include in such notice the fact that insured accounts remain insured for two years from the date of such termination, but it shall not further represent itself in any manner as an insured institution.

Respondent's senior vice president was asked what in his opinion would the consequences be if respondent mailed a notice of termination of its insured status to all its depositors, and he stated [Rep. Tr. 125-126]:

> "I think it would be a mass liquidation of the association. * * * there would just be a shell left after we sent the notice out. * * * I don't believe that if we sent such a letter out indicating that we were going to cancel this insurance that we could anticipate anything except the fact that we would have a mass liquidation and withdrawal of accounts."

In other words, giving notice of termination of its status as an insured institution would simply be impossible as a practical matter. It would be tantamount to suicide from a business standpoint. A right to recover insurance premiums under such dire circumstances must surely be disregarded in the practical realm of Federal income taxation. A right to recover a recurring expenditure only upon pain of going out of business brings into play the same rule of law discussed above, regarding voluntary liquidation. The treatment of an expenditure as an asset or as an expense must be founded upon the "going concern" concept, not a liquidating concept.

C. The Possibility of Refunds if the Primary Reserve Alone Ever Reaches 2 Percent Is Too Indefinite and Uncertain to Render an Expense Non-Deductible.

The plain fact is that Congress and the FSLIC estimated that there would be no such refund (Appendix, pp. 49-50) but that prior to 1995 all the secondary reserve would have been transferred to the primary reserve.

By way of summary, Rev. Rul. 66-49, C.B. 1966-1, 36, rules that the secondary premiums cannot be currently deducted because each such premium "is returnable to it, under specified circumstances."

We have shown that two of such circumstances are inadmissible in disallowing an expense deduction, being dependent upon the liquidation of the taxpayer, and the third is estimated to be non-existent.

We respectfully submit, therefore, that Rev. Rul. 66-49, C.B. 1966-1, 36, is wrong and should be rejected. It is also inconsistent within itself, recognizing that interest credited on the secondary reserve is not taxable

to the insured associations at the time of crediting, because subject to the very limitations and conditions which respondent contends are sufficient to preclude the secondary premium payments from being treated as capital investments. As the Ninth Circuit said below (Appendix, p. 80), "We also believe that the revenue ruling is inconsistent within itself."

V.

The Accounting Treatment Required by Regulatory Authorities Is Not Controlling.

The petitioner (Br. pp. 9, 14, 22) mentions the fact that the Secondary Reserve payments are required by both the Federal and California regulatory authorities to be accounted for as assets and that a certified public accounting firm certifies to its balance sheet as in conformity with generally accepted accounting principles. The petitioner, however, concedes that such requirements are not controlling.

This is understandable, for it was established at an early date, and has been adhered to consistently, that accounting prescribed by regulatory authorities is not controlling in federal income tax determinations.

> *Old Colony Railroad Company v. Commissioner* (1932), 284 U.S. 552, 52 S. Ct. 211, 76 L. Ed. 484.

And we can understand why the Government would not want to assert that a balance sheet certified to by a certified public accountant is binding for federal income tax purposes. For in every company of any magnitude a certified public accountant's certificate will have been issued, but the Internal Revenue Service is not the least deterred from attacking the result for tax purposes, asserting that income has been understated or deduc-

tions overstated. It cannot afford in this case to take the position that the actions either of the regulaotry bodies or the certified public accountants are determinative.

We are not sure why the Federal and California regulatory authorities require the secondary premium payments to be accounted for as assets. But they do, mistakenly, we believe. As a matter of fact, we believe the annual reports of the FHLB contain misrepresentations to the public. For example, the report for 1963 contains the following statement:

> "Savers in insured institutions have four major lines of protection against loss: (1) the substantial loss reserves of the institutions themselves which were in excess of $6.8 billion, or 7.8 percent of savings, as of December 31, 1963; (2) the Insurance Corporation's own reserves of over $944 million at year end." [Ex. 38, pp. 23-24.]

Now, this is just a plain duplication of so-called reserves, and it is repeated in subsequent annual reports of the federal agency. The reserves of the savings and loan associations include the so-called secondary reserve payments, because they are required by this same agency to set them up as assets on their books; and then the same regulatory agency includes the same secondary premium payments as part of its reserve as protecting the savers.

And the accountants do not do a whole lot better. Under their umbrella of "generally accepted accounting principles", they can professionally certify to a balance sheet that may be out of step with reality as long as a regulatory body has espoused it. *Inventory of Generally Accepted Accounting Principles For Business Enter-*

prises, accounting research study by Paul Grady, published in 1965 by the American Institute of Certified Public Accountants, Inc., 52; "The Accountants Are Changing The Rules", Louis, Fortune Magazine, June 15, 1968.

The discrepancy is emphasized by the fact that a national accounting firm feels free to certify respondent's balance sheet, while the General Accounting Office, charged with the duty of auditing the FSLIC, cannot express an opinion regarding the FSLIC balance sheet, as shown hereinafter.

VI.

The Case of Wichita State Bank and Trust Co. v. Comm. Is Irrelevant.

The petitioner (pp. 20-21) relies upon *Wichita State Bank & Trust Co. v. Comm.* (C.A. 5, 1934), 69 F. 2d 595, cert. den. 293 U.S. 562.

The respondent has no quarrel with the principle stated in the *Wichita* case. As the Court of Appeals stated:

> "The contributions to the permanent Guaranty Fund stand otherwise. That fund is not intended to be lost or consumed, but is to stand as a reservoir drawn on to provide prompt payment to depositors, but to be at once replenished by the special assessments. It is analogous to the capital of an insurance company. Each bank owns its pro rata part in it, which it ought ultimately to get back. This bank got back its share by withdrawal from the plan, and it appears that on appeal of the law other banks got back their share."

Thus the *Wichita* case involved a fund which was not intended to be disbursed in payment of insurance losses,

except temporarily, any such disbursement to be immediately replenished with special assessments. This factor clearly distinguishes that case from the present case. Furthermore in that case a bank could simply convert to a bond system and thereby obtain a refund of his assessment, as the taxpayer in that case actually had done. Moreover, the plan itself had been discontinued and the entire fund had been disbursed to the contributors. In the light of these distinguishing factors we do not believe the holding in the *Wichita* case is contrary to anything the respondent has asserted in this proceeding. In fact the case supports respondent, in its holding that the special assessments were deductible when paid and that the subsequent recovery of them constituted taxable income.

VII.

The Legislative History of the 1961 Amendment of the National Housing Act Shows Clearly That the Secondary Reserve Premiums Were Intended to Be True Insurance Premiums to Strengthen the Insurance Reserves of the FSLIC and Were Not Regarded as Capital Investments in the FSLIC.

The petitioner's second argument (Br. pp. 34-38) asserts that the legislative history of the 1961 amendment establishes that the secondary reserve premiums were not insurance premiums at all, but were in the nature of a *temporary* investment in the FSLIC, *i.e.*, a capital expenditure.

We respectfully submit that there is nothing in the legislative history to support petitioner's theory, but that in fact the legislative history supports only the conclusion that the secondary reserve premium is nothing but an insurance premium to add to the insurance re-

serves of the FSLIC and was not intended to be a capital investment—temporary or permanent—in the FSLIC.

The petitioner's argument appears to us to be based upon an error.

We quote from the petitioner's brief (pp. 35-36):

> "Congress also knew in 1961 that the ratio of FSLIC's reserves to its potential liabilities had declined somewhat because of the retirement of the government's stock in FSLIC. S. Rep. No. 778, 87th Cong., 1st Sess., pp. 2, 12; H. Hearings Before Subcommittee on Banking and Currency on H.R. 7108 and H. R. 7109, 87th Cong., 1st Sess., pp. 10, 39. It was concerned with this loss of capital and was faced with the problem of raising capital to replace it. Accordingly, as the Tax Court explained (R. 65), Congress set out to create a temporary pool of capital 'which would serve as a buffer until the FSLIC had accumulated enough of its own income to bring its 'Primary Reserves,' the true insurance reserve, to the desired two percent level.' "

It is also stated (p. 37) that "no sharp line of distinction can be drawn between the FHLB capitalization and the FSLIC Secondary Reserve"; and it is concluded (p. 38) that the Tax Court "was fully justified in its view, [R. 67] as to the 'fungibility' of FHLB stock payments and Section 404(d) payments."

Contrary to the petitioner's statement, we have found nothing whatever in Senate Report No. 778, 87th Cong., 1st Session, either on page 2 or page 12 (which pages are cited by the petitioner), or on any other pages of the report, indicating in any way that retirement of

FSLIC stock had caused its reserve ratio to decline or that the Section 404(d) payments were intended as a capital replacement for any such retired stock.

We sincerely hope this Court will not permit the perpetuation of the Tax Court's erroneous view regarding "fungibility." The FHLB stock and the FSLIC Secondary Reserve are as unfungible as any two things could be.

The Tax Court's opinion and the Commissioner's argument seem to disregard the fact that the FHLB and the FSLIC are separate and distinct entities; they were created for entirely different purposes and at different times; each performs a separate and distinct function, wholly unrelated to the other; and the financial structure of each bears no relationship to that of the other.

Because of the confusion created by the Tax Court's misconception, may we quote directly all that the Senate Committee stated at the beginning of its report under the heading "Purpose of the Bill" and "Background":

"PURPOSE OF THE BILL

This bill is designed to strengthen the Federal Savings and Loan Insurance Corporation which insures savings accounts in savings and loan associations and similar institutions up to a statutory limit of $10,000. Under the bill, supplemental payments would be required by insured associations in order to build up the Corporation's reserve fund. For most institutions, this prepayment requirement would be approximately offset by reducing the stock the institution must purchase in its Federal home loan bank.

Under present law, each insured institution is required to pay to the FSLIC an annual premium of one-twelfth of 1 percent of the accounts of its insured members and its creditor liabilities. Each member institution is also required to purchase stock in its Federal home loan bank amounting to 2 percent of the unpaid principal of outstanding home mortgage loans and other similar obligations.

Under the proposed law, such insured institution would be required to pay a premium prepayment equal to 2 percent of the annual net increase of the accounts of its insured members in addition to the usual one-twelfth of 1 percent annual premium. However, these prepayments to the Insurance Corporation would be offset, in approximately the same amounts, because the bill proposes to reduce the home loan bank stock purchase requirement to 1 percent of outstanding home mortgages and other similar obligations. This would suspend the requirement for additional stock purchases for most member institutions for a number of years.

Due to the rapid growth of insured institutions, the ratio of the Insurance Corporation's reserves to its potential liability has dropped in the past 11 years from 0.843 percent to 0.661 percent. While the reserves of the insured institutions (averaging abut 8 percent) constitute the primary bulwark against losses, and while the net insurance losses have absorbed only 1.1 percent of the Corporation's gross income during its entire life, there is general agreement that the Corporation's reserves should be built up at a faster rate.

Under the bill, prepayments of about $150 million a year are expected, in which case the

combined reserves of the Corporation would reach 1 percent by 1963 and about 1½ percent by 1966. It is considered that this increase in reserves would place the Insurance Corporation in an extremely strong position.

For many years it has been generally recognized that the Federal Home Loan Bank System is overcapitalized. Under the original law, the stock subscription requirement was 1 percent of the aggregate unpaid principal on outstanding mortgages. This was raised to the present 2 percent by legislation enacted in 1950 as a part of the program to accelerate the retirement of Government stock in the banks which has now been accomplished. As far back as 1955 the industry and the administration recommended a reduction of required stockholdings from 2 to 1 percent as provided in the proposed legislation before the committee.

Background

Federal Home Loan Bank System

The Federal Home Loan Bank Act of 1932 created the Home Loan Bank System. Under the authority of this act, 12 district home loan banks (reduced to 11 in 1946) were organized with capital subscribed by member institutions and by the U.S. Treasury. Funds for lending were obtained principally from borrowings on the open market and from retained earnings of the banks. The System was fundamentally designed as a reserve credit facility for savings and home mortgage credit institutions. Under the original law, each member institution of a Federal home loan bank required to hold stock in its bank equal to 1 percent of the aggregate unpaid principal of its

home mortgage loans, subject to a required minimum. By legislation enacted in 1950, as a part of the program for accelerating the retirement of the Government stock in these banks, the required amount of stock was approximately doubled, being increased to 2 percent of the aggregate unpaid principal of the member's home mortgage loans, home-purchase contracts, and similar obligations.

Federal Savings and Loan Insurance Corporation

The Federal Savings and Loan Insurance Corporation is a Government Corporation. It was created by the Congress through legislation approved by the President on June 27, 1934. The purpose of the Corporation is to provide safeguards for savings by insuring the accounts of each saver or investor in eligible institutions of the savings and loan type. In order to qualify for insurance, applicant institutions must fulfill specific requirements with respect to such features as management, financial policies, and financial condition.

The Federal Savings and Loan Insurance Corporation insures the savings of each member or investor in an insured institution up to $10,000. The Corporation operates under the direction of the Federal Home Loan Bank Board, and expenses are completely met from its income, which consists principally of premiums paid by savings and loan associations, interest on its investments, and admission fees."

We submit there could be no more clear enunciation of the distinct functions and purposes of the two entities. The FSLIC needed additional insurance re-

serves, and this need arose from "the rapid growth of insured institutions."

The Chairman of the FHLB testified that "The failure of the reserve ratio of the Corporation to increase during the intervening period is caused solely by the rapid growth of the insured institutions." H. Hearings Before Subcommittee on Banking and Currency on H. R. 7108 and H. R. 7109, 87th Cong., 1st Sess., p. 10.[3]

That the secondary payment was intended by Congress to be a true insurance reserve, rather than a replacement of capital, is emphasized in the following quotation from H. Rep. 823, 87th Cong., 1st Sess., p. 3:

> The bill will not affect the regular premiums paid into FSLIC until the Corporation's primary reserve (which means, roughly, the reserve which would be built up under present law without this bill) equals 2 percent of the accounts of insured savers plus the creditor obligations of insured insured institutions. FSLIC estimates this will happen sometime between 1993 and 1995. When that happens, premium payments will be suspended until the ratio drops below 2 percent, when they will be resumed.
>
> The premium prepayments required by the bill will be credited to a secondary reserve, available to pay any losses not covered by other FSLIC resources. When the primary and secondary re-

[3]Testimony of the chairman of the legislative committee of the U. S. Savings & Loan League mentioned retirement of FSLIC stock, but this was nowhere even mentioned by either Congressional Committee. See H. Rep. 823 and S. Rep. 778, 87th Cong., 1st Sess.

serves together reach the 2 percent level, the requirement for premium prepayments will be suspended until the ratio drops to 1.75 percent, when they must be resumed. FSLIC projections indicate the two reserves together will reach 2 percent for the first time in 1970. Thus, if the projections are correct, the bill would produce a 2 percent ratio about 25 years sooner than present law would.

Thus, the two reserves were intended to serve exatcly the same purpose—that of a reserve for insurance losses.

The two reserves are so treated by the FSLIC. In the FHLB Annual Report for 1963 (pp. 23-24) it was reported to the Congress and to the public that savings depositors were protected by certain factors, including:

> "the Insurance Corporation's own reserves of over $944 million at year end, *which are accumulating more rapidly than in the past under legislation passed by Congress in 1961*." [Ex. 38, pp. 23-24; emphasis added.]

The Comptroller General of the United States audits the FSLIC. In his report to the Congress of the United States dated May 23, 1967, covering the period July 1, 1963 through December 31, 1965, there is nothing whatever that would indicate that the secondary reserve serves any purpose different from that of the primary reserve, and on the balance sheets attached as part of the report the primary reserve and the secondary reserve are listed under the heading "Reserves" and their combined totals set forth. [Ex. 43, p. 29.] The report, under the heading "Opinion on Financial Statements", includes the following statement:

"The Corporation's primary and secondary reserves established pursuant to law are available to meet future losses. These reserves are not a measure of the insurance risk which is dependent on future economic conditions, and therefore the adequacy of these reserves is not determinable." [Ex. 43, p. 27].

And on page 2 of the letter of transmittal accompanying the report the following is stated:

"The financial statements accompanying this report have been prepared by the Federal Savings and Loan Insurance Corporation. Because we could not determine the adequacy of the primary and secondary reserve and the allowances for losses, and because the Corporation does not disclose in its financial statements the possible adverse effect that the impaired financial condition of certain insured associations might have on the Corporation's financial position and results of operations, we cannot express an overall opinion on the accompanying financial statements for the 18-month period ended December 31, 1964, and for the calendar year 1965."

We respectfully submit that as far as the Comptroller General is concerned the secondary reserve serves exactly the same purpose as the primary reserve. And the comment in his "Opinion on Financial Statement" serves to emphasize respondent's position that the secondary reserve is entirely beyond its control, "dependent on future economic conditions", rendering the adequacy of the reserves indeterminate.

Petitioner places emphasis upon the fact that the primary premiums are treated by the FSLIC as income,

whereas the secondary premiums are credited directly to the Secondary Reserve.

We fail to see any significance in such accounting treatment. Section 1727(d) specifies that the secondary premium shall be "credited to the Secondary Reserve", and hence the FSLIC is merely complying with the wishes of Congress in this accounting treatment. Such accounting is consistent with the Congressional mandate in Section 1727(e) that the Secondary Reserve "shall be available to the Corporation only for losses of the Corporation and shall be so available only to such extent as other accounts of the Corporation which are available therefor are insufficient for such losses."

But the crucial point is that the secondary premiums are available for losses. Thus they are nothing but insurance premiums. Whether they are accounted for as income of the FSLIC is utterly unimportant to respondent or other insured institutions. And it must likewise be immaterial to the FSLIC, since it is a nontaxable entity in any event.

Furthermore, as the Ninth Circuit stated below (Appendix, p. 78), "We think the emphasis upon the treatment of the receipt by the payee, FSLIC, is mistaken and that in determining whether an expense is an ordinary and necessary expense of doing business, the focus should be on the taxpayer and the taxpayer's business, not on what the payee does with the money paid. * * *"

The petitioner also refers repeatedly throughout its brief to the words "retained earnings", apparently referring to the primary premiums minus expenses and losses. We have searched the legislative history and the annual reports of the FHLB and have found no

mention of a concept of "retained earnings". This concept of "retained earnings" was apparently created by the Tax Court (Appendix, p. 66) as part of its attempt to equate the secondary reserve to a "pool of capital", thereby attempting to use the analogy of an ordinary commercial corporation, where there is a distinction between capital, on one hand, and surplus (including retained earnings).

But this analogy is wholly meaningless here. As shown above, the FSLIC is a non-stock, non-profit, mutual insurance company. The concepts of income and retained earnings are irrelevant. All that matters is that insurance premiums collected by the FSLIC, in excess of expenses and losses, constitute a reserve for insurance losses.

Conclusion.

For the reasons stated, the judgment of the court of appeals should be affirmed.

Respectfully submitted,

A. CALDER MACKAY,
ADAM Y. BENNION,
RICHARD N. MACKAY,
VICTOR L. WALCH,
Attorneys for Respondent.